

RatingsDirect®

Seattle, Washington; Retail Electric

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Seattle, Washington; Retail Electric

Credit Profile

US\$183.555 mil mun light and pwr imp and rfdg rev bnds ser 2013 due 07/01/2042

Long Term Rating

AA/Stable

New

Seattle muni lt & pwr rev bnds

Long Term Rating

AA/Stable

Upgraded

Seattle mun lt & pwr imp & rfdg rev bnds

Unenhanced Rating

AA(SPUR)/Stable

Upgraded

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services raised to 'AA' from 'AA-' its rating on Seattle, Wash.'s municipal light and power system's parity lien debt. At the same time, we assigned a 'AA' rating to the series 2013 improvement and refunding revenue bonds of the system, which does business as Seattle City Light (SCL). The outlook is stable.

The upgrade is based on financial management strategies that have significantly increased reserves, and reduced the impact on the system's financial margins of wholesale electricity market volatility.

Other ratings strengths include:

- A low-cost hydro-based generation portfolio that can meet demand under most water conditions, including less-than-normal water conditions;
- A strong and diverse customer base; and
- Competitive retail rates, despite significant increases in the past few years.

Offsetting factors include some reliance on wholesale sales, and what we view as a large capital improvement program (CIP) that management expects will add \$1.2 billion of debt in the next six years.

Seattle pledges the light system's gross revenues to pay debt service on the 2013 bonds. It expects to use bond proceeds to fund improvements at the electric system's Boundary hydroelectric project, other capital improvements and conservation programs, and to refund some parity debt.

SCL is a municipally owned electric utility that provides service to approximately 402,600 customers in Seattle and surrounding areas within King County, covering a population of 781,000. Debt totaled about \$1.8 billion as of March 1, 2013.

We believe SCL's business position is satisfactory ('3' on our scale of '1' to '10', with '1' being excellent) due to its ability and willingness to adjust rates to support the utility's financial health, a large and diverse customer base with low industrial concentration, and a supply of low-cost hydroelectric power that is sufficient to cover native demand as well as energy for wholesale sales. In our view, challenges include managing hydrology and market risks related to its high

dependence on hydroelectric power generation for wholesale sales. Rates are about average for the state but we believe they are very competitive relative to the national average and those of other large utilities in the region.

Historically, SCL relies on wholesale sales for strong debt service coverage (DSC). Wholesale sales revenue has ranged from 8% to 21% of total operating revenue in the past 10 years, with a declining trend. Management intends to lower its reliance on wholesale sales to reduce volatility of financial performance. As part of its strategy, over the past several years, the city council has enacted a series of annual base rate increases, and has established a rate stabilization account, which held \$128 million as of fiscal year 2012. A debt restructuring and a temporary rate surcharge in 2010 were significant components of the initial rate-stabilization account funding plan. In addition to the base rate increases since fiscal 2010, management has included modest annual rate increases to its base rate through 2015 in its financial forecast.

SCL management projects that the rate stabilization account balance will remain at or above \$79 million through 2015, but that surcharges are likely to be implemented in 2014 and 2015 to increase the balance to management's target level of \$100 million. A portion of wholesale net revenues comes from forward sales of typically nine months or less, and SCL maintains strict limits on the portion of its surplus made available for forward sales to avoid potentially high replacement power costs in low-water years. Standard & Poor's believes the system's risk management policies are conservative, and adequately reduces the risk related to its forward sales.

We believe SCL's overall financial performance is good, with strong DSC during fiscal 2005 to 2012 of 1.5x to 2x. The exception was a decline in DSC in fiscal 2009 to about 1.2x. Standard & Poor's calculates coverage by including city taxes as an expense. Fixed-charge coverage (of both debt service and purchase power obligations) has also been strong, in our view, exceeding 1.26x in the past two years.

Outlook

The stable outlook reflects Standard & Poor's expectation that SCL will maintain adequate liquidity and DSC through rate-stabilization policies and continued conservative wholesale revenue forecasting. We believe these improved financial practices will contribute to credit stability. The rating could be lowered if SCL fails to maintain consistently strong financial performance. We do not expect to raise the rating in the next two years.

Diverse Customer Base

SCL's service area consists principally of Seattle, but it also has franchise agreements with several cities within King County and some incorporated areas that in total account for about 18% of energy sales. Management estimates the population of its service area at 781,000. While the customer base is primarily residential, two-thirds of retail sales are to commercial and industrial customers. While flat since 2006, 2011 retail sales of 9,600 gigawatt-hours reflect 1% compound annual growth since 2003. SCL forecasts modest annual growth, due in part to Seattle's increased conservation efforts. Peak demand of 1,797 megawatts (MW) in 2012 is about 5.4% below 2008's peak, reflecting a combination of conservation efforts and slowed economic activity, although 2012's figure is up significantly from the prior year. The customer base is diverse, with the 10 leading customers accounting for about one-sixth of revenues.

Strong Hydrological Assets Provide Low-Cost Power

Low generating costs, a very high reliance on hydroelectric generation, and large surplus generation capacity in most months characterize SCL operations. The system's hydroelectric generating assets are distributed between the Columbia River-based Federal System and two other independent river systems. Owned-generating assets, with an average production cost of under \$10 per megawatt-hour, include the Boundary project and the Skagit River projects, representing 26% and 16% of total resources, respectively. Additional resources include a maximum of 175 MW from the Stateline Wind Project. In 2013, the Federal Energy Regulatory Commission extended the Boundary project's license to 2055.

SCL's block-and-slice allocations under its current contract with the Bonneville Power Administration (BPA) are sized to bring the utility into load-resource balance under critical water conditions, with the goal of considerably reducing its supply risk for its retail operations. The system's 17-year contract with BPA became effective October 2011, and provides SCL with BPA's block-and-slice products that are designed to more closely balance its firm resource requirements.

Nevertheless, this reliance introduces a measure of hydrological and wholesale power market risk to SCL in achieving its financial targets. A significant portion of wholesale net revenues comes from forward sales of typically nine months or less. The system has adopted risk-management policies and forward sales guidelines, which establish limitations on the timing and quantity of forward sales to avoid potentially high replacement power costs when hydroelectric power supplies fall short of expectation. Standard & Poor's also believes that the recent rate-stabilization account ordinance will offset much of the budgetary risk, since rate surcharges are triggered automatically in the event that the account balance falls below \$90 million.

Finances

Financial flexibility is adequate, in our view, given the city council's ability and willingness to set rates to support SCL's financial position. The city has adopted modest retail rate increases in the past two fiscal years, and its forecast indicates a continuation of this trend through at least 2014.

Following strong operating results in 2011 and 2012, unrestricted cash and investments and other available reserves in the rate stabilization account as of the fiscal year ended Dec. 31, 2012, totaled \$285 million, or what we consider a sound six months of expenditures. Seattle also has access to interdepartment loans from a sizable common fund, which is estimated at \$1.4 billion. We believe debt leverage is high but stable, and is expected to remain at management's target of 61% through 2015. However, capital requirements are high at about \$2 billion in 2013-2018, of which \$1.2 billion will require debt issuance. No specific project dominates, although 44% of the CIP's costs are distribution projects, including new substations and upgrades to existing services. City resolution specifies that capital funding contain not less than 40% from operations, which we expect will result in a debt leverage consistent with the city's target. SCL has no floating-rate debt.

SCL projects consistently strong coverage at slightly above recent levels. It also expects combined DSC of at least 1.8x

through 2015. Given the debt plans, ongoing financial performance will be influenced by the extent to which SCL is able to generate sufficient net income to support its capital program, and incorporate rate increases according to plan. The increased rates will support superior coverage levels that are consistent with ratings in the 'AA' category.

Related Criteria And Research

USPF Criteria: Electric Utility Ratings, June 15, 2007

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